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FEE GUIDELINES STILL NEEDED FOR GOVERNMENT-SPONSORED NONPROFIT --ETC(U)  
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REPORT BY THE U.S.

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# General Accounting Office

## Fee Guidelines Still Needed For Government-Sponsored Nonprofit Organizations

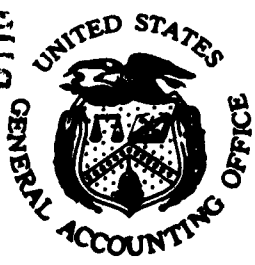
The variety of procedures used to determine and pay fees to Government-sponsored nonprofit organizations continues to reflect a lack of uniformity in Federal policy.

The weighted guidelines used by the Department of Defense in determining fees for the organizations GAO reviewed are not appropriate. Weighted guidelines support historical rates sufficiently large to accumulate reserves, despite alternatives available to minimize or eliminate the need for such reserves.

This report supports GAO's 1969 recommendation that the Director, Office of Management and Budget, through the Office of Federal Procurement Policy, develop uniform fee guidelines for Government-sponsored nonprofit entities.

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UNITED STATES GENERAL ACCOUNTING OFFICE  
WASHINGTON, D.C. 20548

PROCUREMENT, LOGISTICS,  
AND READINESS DIVISION

B-202331

The Honorable Max S. Baucus  
United States Senate

Dear Senator Baucus:

As requested in your September 9, 1980, letter, we have assessed the reasonableness of fees paid by Federal agencies to Government-sponsored nonprofit organizations. This issue was addressed in our 1969 report on Government-sponsored nonprofit organizations and in our 1971 report on nonsponsored nonprofit organizations. As a group, these organizations receive most of the cost-plus-fee contract awards made to nonprofit organizations, and their operations have historically been controversial.

The report identifies why fees are paid to Government-sponsored nonprofit organizations and how certain organizations are able to accumulate relatively large capital reserves through fees. We have concluded that our 1969 recommendation for fee guidelines is still valid.

As arranged with your Office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of the report. At that time, we will send copies to interested parties and make copies available to others upon request.

Sincerely yours,

Donald J. Horan  
Director



A

GENERAL ACCOUNTING OFFICE  
REPORT TO THE HONORABLE  
MAX S. BAUCUS  
UNITED STATES SENATE

FEE GUIDELINES STILL NEEDED  
FOR GOVERNMENT-SPONSORED  
NONPROFIT ORGANIZATIONS

D I G E S T

Government-sponsored nonprofit organizations are private concerns performing Government work. Many receive cost-plus-fixed-fee contracts and are assigned work without competition. Thus, they are insulated from the traditional market pressures that confront commercial and independent nonprofit organizations. In fiscal year 1979 these organizations received about three-fourths of the cost-plus-fee type of contract awards made by Federal agencies to nonprofit organizations, including an estimated \$30 million in fees.

This report is in response to a request from Senator Max Baucus, who wanted an assessment of the reasonableness of fees paid to nonprofit organizations that are dependent on Federal contracts.

Payment of fees to such entities has long been controversial. Because these Government-sponsored nonprofit organizations are organized by Federal agencies to support the mission of their sponsors, opponents of fees argue that these organizations are quasi-governmental and therefore should not receive a fee. Proponents, on the other hand, believe fees are necessary to meet certain financial obligations not covered under contracts. (See p. 4) They justify fees to accumulate reserves for working capital, to acquire facilities, to provide insurance against contract termination, and to pay for independent research and certain normal nonreimbursable costs. (See p. 6.)

In 1969, because fees were not being used as intended and because of the diversity of methods and rates in existence, GAO recommended that the Office of Management and Budget, then known as the Bureau of the Budget, prescribe Government-wide guidelines for Government-sponsored nonprofit organizations.

NEEDS OF THREE GOVERNMENT-  
SPONSORED ORGANIZATIONS MAY BE  
BETTER MET THROUGH OTHER MEANS

GAO reviewed three Government-sponsored nonprofit organizations and found that fees were no longer needed to accumulate reserves for working capital. The current reserves of these three organizations exceeded estimated working capital requirements by more than \$18 million. The three organizations claimed the additional reserves were necessary to protect them in the event of contract termination. GAO believes reserves for this contingency, however, may also be accommodated through special termination contingency clauses in the contract. (See p. 8.)

Two of the organizations were also using accumulated reserves to purchase new facilities. In April 1962 the Bureau of the Budget issued a report which stated that where facilities are required to perform work for the Government, the Government should either provide the facilities or cover their cost as a part of the contract. GAO does not challenge the appropriateness of using fees to provide for facilities after all alternatives have been explored. However, GAO questions the advisability of allowing fees to accumulate when no need for capital expansions has been identified. (See p. 9.)

AGENCY PROCEDURES FOR DETERMINING  
FEES CONFLICT WITH FEE PURPOSE

Three of the four Federal agencies sponsoring nonprofit organizations use methods to determine fees which are not based on needs criteria. The Department of Defense (DOD) used the weighted guidelines method to determine fees for the three Government-sponsored nonprofit organizations reviewed. Weighted guidelines, in GAO's opinion, are not appropriate for determining fees for sponsored nonprofit organizations. Their purpose is to reward owners of a business for investing capital and for performance which is not coincident with the underlying purpose of paying fees to sponsored organizations--to provide for legitimate financial needs not covered under the contract. (See p. 11.) The National Aeronautics and Space Administration used negotiated fee schedules to determine fees paid to a university. The Department of Energy used a management allowance which more nearly resembled the needs approach of the National Science Foundation than DOD. (See p. 12.)

The National Science Foundation was the only agency sponsoring nonprofit organizations that determined fees based on need.

#### FEE GUIDANCE IS NEEDED

Of the two general procurement guidelines, the Defense Acquisition Regulations and the Federal Procurement Regulations, only the Defense Acquisition Regulations provide guidance for contracting with Government-sponsored nonprofit organizations.

The Defense Acquisition Regulations set out the modified weighted guidelines, which GAO believes are inappropriate. (See p. 14.)

#### CONCLUSIONS

Based on GAO's current review, GAO believes its 1969 recommendation is still valid and should be implemented. Furthermore, as part of such guidelines, GAO also believes that the Office of Federal Procurement Policy should consider how agencies may best provide for termination and nonrenewal contingencies. The Office of Federal Procurement Policy has solicited comments on a proposal that would promulgate guidelines for the establishment, use, periodic review, and termination of Federally Funded Research and Development Centers. GAO believes this may also be a good vehicle for fee guidance.

#### AGENCY AND CONTRACTOR COMMENTS AND GAO'S EVALUATION

While the four Federal agencies sponsoring nonprofit organizations either supported or did not object to GAO's recommendation, they stressed the need for flexibility. In addition, although DOD said it did not object to the recommendation, it believed that the recommendation is unnecessary and not cost effective for its purposes. The three nonprofit organizations generally believed their fees were reasonable and necessary. Consequently, they objected to the recommendation.

GAO believes that the recommendation is applicable to Defense and that fees being paid to the three organizations may not be the best way for the Government to meet these organizations' needs. Chapter 5 discusses the organizations' and agencies' comments in detail.

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#### ABBREVIATIONS

DAR	Defense Acquisition Regulation
DOD	Department of Defense
FFRDC	Federally Funded Research and Development Center
FPR	Federal Procurement Regulation



## CHAPTER 1

### INTRODUCTION

Payment of fees to nonprofit organizations has long been controversial. Fees on Federal contracts are the amounts negotiated and paid on cost-type contracts in addition to all reimbursable costs and are usually described as a rate or a percentage of estimated contract costs. Part of the difficulty regarding fees paid to nonprofit organizations is that the term "fee" is misleading. The reason for paying fees to nonprofit organizations differs from the reason for paying fees to for-profit organizations. Fees paid to for-profit organizations are viewed as contributions to profits, whereas fees paid to nonprofit organizations are considered necessary to provide required operating capital and to cover certain nonreimbursable expenses. In addition, the tax exempt status of nonprofit organizations about doubles the value of the fee when compared to for-profit organizations. For example, a 5- to 6-percent fee paid to a nonprofit organization is considered equivalent to a 10-percent fee paid to a for-profit organization.

Senator Max Baucus asked us to examine the reasonableness of fees paid to certain nonprofit organizations dependent on Federal contracts. Appendix IV is a summary of Senator Baucus' request.

### GOVERNMENT-SPONSORED NONPROFIT ORGANIZATIONS

According to the statistics available through the Federal Procurement Data System, the amount of cost-plus-fixed-fee contracts awarded by Federal agencies to nonprofit organizations is concentrated in a relatively small and unique group of contractors called Federally Funded Research and Development Centers (FFRDCs). (See app. I.) In fiscal year 1979, 1/ nonprofit organizations received about \$1.9 billion in cost-plus-fee contracts over \$10,000. Of the \$1.9 billion, \$1.5 billion, including about \$30 million in fees, was awarded to 17 FFRDC-type organizations sponsored by the Department of Defense (DOD), including the Navy and Air Force; the Department of Energy; the National Aeronautics and Space Administration; and the National Science Foundation (NSF). The remaining \$0.4 billion was awarded primarily to independent nonprofit organizations.

The term, FFRDC, was created by NSF for reporting on Government contracting for research, development, and other scientific activities. NSF categorizes Federal obligations as going to universities and colleges, university-administered FFRDCs,

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1/The latest year that a full year of data was available through the Federal Procurement Data System.

and independent nonprofit institutions and nonprofit-administered FFRDCs. The term FFRDC is used to identify a broad spectrum of organizations having special relationships with Federal agencies, including Federal contract research centers as they are designated in DOD, as well as some for-profit organizations.

FFRDCs are considered unique because they were initially established to assist the Government in accomplishing a particular mission that could not be accomplished either through Federal laboratories or through the private sector. For example, the Applied Physics Laboratory at Johns Hopkins University was organized in 1942 at the request of the wartime Office of Scientific Research and Development. It gave central direction and technical support to an association of universities and industrial contractors being organized to develop new concepts for weapon systems.

NSF states that to qualify as an FFRDC, an organization should

- perform primarily at least one of the following: research, applied research, development, or management of research and development;
- be organized as a separate operational entity within the parent organization or as a separately incorporated organization;
- perform either on a direct request of the Government or under a broad charter from the Government, but in either case under the direct monitorship of the Government;
- receive its major financial support--70 percent or more--from the Government, usually one agency;
- have, or be expected to have, a long-term relationship--about 5 years or more--with its sponsoring agency as evidenced by the specific obligations it and the agency assume;
- be established in the contract so that most of all the facilities are either Government owned or funded; and
- have an average annual budget, including operating and capital equipment, of at least \$500,000.

Because of their special relationship with Federal agencies, FFRDCs, in the past, have been the source of much controversy.

Some of the claimed advantages of FFRDCs include

- quick startup capability,

- ability to attract and retain high quality staff,
- high quality research and development output,
- objectivity in research and development output,
- relative freedom from conflict of interests,
- relative freedom from bureaucratic red tape,
- freedom from using resources to promote new work,
- intimate familiarity with sponsoring agency's needs,
- good communication of research and development results,
- high degree of interdisciplinary capabilities, and
- quick response to change in mission.

Despite claimed advantages, their special relationship has also led to claims that FFRDCs have a number of serious disadvantages, such as

- adverse effects on developing and maintaining Government in-house research and development competence,
- absence of sufficient market discipline to stimulate efficient operations,
- unfair advantages in obtaining Federal research and development work,
- high costs relative to other types of Federal research and development performers, and
- activities that include decisionmaking responsibilities that should properly be retained as a governmental function.

Because of the claimed advantages and disadvantages and because FFRDCs are private organizations established and maintained by Federal agencies, one of the major issues surrounding FFRDCs is where to draw the line between the independence they claim they need to perform and the accountability the public has a right to expect. Whether they should receive fees and how much have been among the most controversial issues surrounding these organizations. See appendix II for a chronology on FFRDC fee-related events.

## WHY GOVERNMENT-SPONSORED NONPROFITS RECEIVE FEES

In April 1962 the President approved the Bureau of the Budget Committee's report on "Government Contracting for Research and Development," commonly called the Bell report. The Bell study was undertaken to determine whether the Government, in contracting for research and development, should be paying fees to nonprofit organizations. The report concluded that fees were needed by nonprofit organizations and were justified to perform independent research and to give some degree of operational stability and flexibility. Thus, the Bell report established certain needs as the justification for paying fees to these types of organizations. The Bell report, nevertheless, was concerned with independent nonprofit organizations and presumed fees would be negotiated between Government and contractor "in accordance with the independent relationship that is essential to successful contracting."

However, because FFRDCs are sponsored, usually by one Federal agency, opponents of fees argue that these organizations are essentially quasi-governmental, and therefore, should not receive a fee. Proponents, on the other hand, believed fees were necessary to meet certain financial obligations not covered under contracts. The latter position has prevailed. As the Air Force indicated in its 1966 report on sponsored nonprofit organizations, there has been a general acceptance that such sponsored-organizations have legitimate, normal business expenses that cannot be reimbursed under defense contracting regulations.

In 1969 we reviewed the purpose, amount, and use of the fee provided for sponsored, nonprofit organizations. At that time we concluded that the purpose established for fees had not been accomplished and that the fees and the bases used for determining fees varied significantly among Government agencies. We recommended that the Bureau of the Budget (now the Office of Management and Budget) prescribe Government-wide guidance to agencies contracting with sponsored nonprofit organizations. The recommended guidelines were to limit the fees to the amount needed to enable the organizations to accumulate a reserve to provide operational stability and to pay prudent business expenses not otherwise reimbursable. To date, no such guidelines have been promulgated.

Instead, Federal agencies use either the Defense Acquisition Regulation (DAR) or the Federal Procurement Regulations (FPR) as a basis for fee negotiations with Government-sponsored, nonprofit organizations. Neither provide guidance as to what constitutes operational stability or prudent business expenses. DOD guidance (called weighted guidelines) stresses reward by assigning values or weights to various cost factors to determine a fee.<sup>1</sup> They include negative weights for nonprofit and sponsored organizations.

(See app. III.) FPR guidance is even more general. We discuss both of these regulations in detail in chapter 4.

#### OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of our review was to assess the reasonableness of fees paid to selected Government-sponsored nonprofit organizations based on their need. To do this, we surveyed six Federal agencies--DOD, including the Navy and Air Force; the Department of Energy; the National Aeronautics and Space Administration; and NSF--who had been identified as sponsoring agencies by NSF. We looked at how each of these agencies determined the fees paid to their sponsored organizations. We also reviewed contracts between the Environmental Protection Agency and the Department of Health and Human Services and at least one DOD-sponsored nonprofit organization to see how they determined fees.

We examined the financial records of three DOD-sponsored nonprofit organizations--the Institute for Defense Analysis (IDA), MITRE Corporation, and Johns Hopkins University/Applied Physics Laboratory (JHU/APL). We selected these organizations because they are in the Washington area. Although contracts with JHU/APL are currently reported by NSF as awards to a university, JHU/APL was previously reported as a university-administered FFRDC. It still receives cost reimbursements under DAR guidelines for commercial organizations where it is more normal to receive a fee than under DAR guidelines for educational institutions. It also generally meets the criteria set out for FFRDCs by NSF.

We also reviewed Federal procurement regulations and numerous articles and reports relative to the issues of Government-sponsored nonprofit organizations. Further, we talked with officials at the Office of Management and Budget to determine what guidance, if any, they were providing for contracting with Government-sponsored organizations. We also talked with Internal Revenue Service officials about paying fees to nonprofit organizations and about how they assessed working capital. Finally, we talked with Defense Contract Audit Agency officials about their audits of each of the sponsored nonprofits we reviewed. We performed our work in accordance with our current "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions."

## CHAPTER 2

### NEEDS OF THREE GOVERNMENT-SPONSORED NONPROFIT

#### ORGANIZATIONS MAY BE BETTER MET THROUGH OTHER MEANS

Government-sponsored organizations believe they have needs for revenues over and above the reimbursable costs of their contracts. For example, MITRE, JHU/APL, and IDA believe such revenues are necessary to pay nonreimbursable expenses and to accumulate capital for working expenses, new facilities, and termination liabilities should their contracts not be renewed. In recognition of such needs, DOD pays fixed percentages of their estimated reimbursable costs as a general level of financial support. Historically, DOD has paid 3.4 percent to JHU/APL, 3.5 percent to MITRE, and 4.25 percent to IDA. In this chapter, we examine the use of fees paid to these three DOD-sponsored nonprofit organizations.

#### USE OF FEES

The rationale for paying fees to Government-sponsored nonprofit organizations is to provide operating stability and to cover certain nonreimbursable expenses. We categorize the use of fees as needed for nonreimbursable expenses, working capital, and general support capital. These last two categories represent that portion of total corporate capital used to provide stability in operations. The total capital of these organizations essentially represents the excess, since inception, of fees over nonreimbursable expenses. Total capital as of fiscal year 1979 was \$26.6 million for JHU/APL, \$16.8 million for MITRE, and \$4.8 million for IDA.

#### Nonreimbursable expenses

Under cost-plus-fee-type contracts, the Government reimburses organizations for allowable, allocable, and reasonable direct and indirect costs. Direct costs relate directly to a contract and may include such expenses as materials and labor. Indirect costs do not relate directly to a contract and may include such expenses as depreciation, maintenance, and repairs.

Some normal business expenses, however, are not reimbursable under Government regulation. For example, some expenses DAR deem unallowable, in whole or in part, include advertising, bad debts, contributions and donations, interest on borrowings, relocation cost in excess of prescribed limits, excessive recruiting costs, and the difference in cost between first class travel accommodations and less than first class accommodations. In some instances, where assets are acquired with funds provided by the Government, depreciation may not be allowed.

Some of the typical nonreimbursable expenses we found paid for by the fee were business luncheons, educational benefits, employee

relations, interest, donations, parent organization administration, and independent research. At the organizations we reviewed, the fee was more than adequate to pay all nonreimbursable expenses. The following table shows the fees paid to each organization for fiscal year 1979 and the nonreimbursable expenses. The excess is the amount left from fees after covering nonreimbursable expenses. It is added to corporate capital for fiscal year 1979. These figures differ somewhat from the amounts reported as added to capital for fiscal year 1979 because we did not include investment and other income.

	<u>MITRE</u>	<u>JHU/APL</u>	<u>IDA</u>	<u>Total</u>
Fee	\$5,663,900	\$2,491,141	\$669,360	\$8,824,401
Less nonreimbursable expenses	<u>3,416,900</u>	<u>953,563</u>	<u>410,495</u>	<u>4,780,958</u>
Added to capital	<u>\$2,247,000</u>	<u>\$1,537,578</u>	<u>\$258,865</u>	<u>\$4,043,443</u>

#### Working capital

It is generally recognized that a portion of total corporate capital is needed as working capital to provide operational stability to the organization. Working capital is the current assets in excess of current liabilities that are available for paying operating expenses if revenues do not match requirements to pay expenses. The excess fees added to corporate capital are used to provide adequate current assets to support a level of working capital sufficient to meet the operational needs of these organizations. Thus, in assessing the use of fees, we reviewed the adequacy of working capital at each organization. In doing this we used an operating cycle approach.

The operating cycle approach to determine the amount of needed working capital has been used by the tax courts, the U.S. Court of Claims, and the U.S. Court of Appeals. Basically, it involves a computation of the amount necessary to run the business for one operating cycle. For service organizations, the operating cycle is the average number of days it takes to collect accounts receivable. At the time of our review, MITRE's operating cycle was 21 days, JHU/APL's was 23 days, and IDA's was 60 days. The amount of working capital required to carry the corporation through one operating cycle is determined by multiplying the annual operating expenses (less depreciation since it does not require a cash outlay) by a fraction (the numerator is the operating cycle and the denominator the number of days in the year, 365). The resulting figure, the liquid assets necessary to meet ordinary operating expenses for a complete operating cycle is then compared to the corporation's working capital; current assets less current liabilities. Our comparison of these organizations' working capital and their operating expense requirements for fiscal year 1979 is shown on the following page.

	<u>MITRE</u>	<u>JHU/APL</u>	<u>IDA</u>	<u>Total</u>
Working capital	\$9,013,100	\$17,953,466	\$4,325,626	\$31,292,192
Operating expense requirement	<u>6,973,444</u>	<u>3,400,000</u>	<u>2,634,332</u>	<u>13,007,776</u>
Difference	<u>\$2,039,656</u>	<u>\$14,553,466</u>	<u>\$1,691,294</u>	<u>\$18,284,416</u>

The comparison indicates that these three organizations have accumulated more than adequate working capital to cover operating expenses for one operating cycle. This conclusion is further supported by a Defense Contract Audit Agency's (DCAA's) audit of MITRE's use of fees. Its conclusion was that the capital surplus accumulation, including working capital through July 31, 1979, was more than adequate to meet MITRE's operating needs and provide financial stability. DCAA reached its conclusion based on (1) observed changes in working capital between 1974 and 1979, (2) the fact that MITRE's average monthly expenditures were about \$9.8 million, and (3) the fact that MITRE submitted bi-monthly vouchers which the Air Force paid in approximately 5 days. Furthermore, in a comparison of MITRE with other nonprofit organizations, DCAA found that with one exception, MITRE had the highest working capital ratio (current assets divided by current liabilities). In the case of JHU/APL, we found that working capital needs were minimized by an advance payment provided by the Navy. In our comparison of operating expense requirements to working capital, we used the amount agreed to under the advance payment arrangement as needed for operating expenses. The relatively large excess of working capital to operational expense requirements at JHU/APL is accumulated under an agreement between the Navy and JHU/APL to support a stabilization and contingency fund which we discuss later.

We observed that IDA's excess working capital is corroborated by its practice of paying for cost overruns out of its fees. In 1979 this amounted to over \$200,000. While it is expected that certain nonreimbursable expense will be paid for with the fee, cost reimbursable contracts are used for research work specifically because cost estimates are not expected to be accurate. Since these costs are normally reimbursable, we believe IDA could not afford to cover them with its fee if working capital were not more than adequate.

#### General support capital

Beyond working capital needs, all these organizations believe that the excess fees added to capital are justified as reserves for contract termination and/or for capital expansion. We estimated this to be \$14.5 million at JHU/APL, \$2 million at MITRE, and \$1.7 million at IDA, for fiscal year 1979.



### Contingency needs

We found that while IDA believes such capital accumulation is justified for termination contingencies, it had not specified what its requirements were.

At MITRE we found that the Air Force has historically provided for termination and nonrenewal contingencies through a special clause in its contract. At the time of our review, the Air Force had included this clause in its contract with MITRE. However, due to what an Air Force official described as an administrative delay, the clause had not been approved. Air Force contracting officials said it was not their intention to discontinue this practice and that they were working on reinstating the clause, in order to provide for this need in an economical way.

JHU/APL, in an arrangement with the Navy, maintains a stabilization and contingency fund to provide it with working capital and reserves in case its contract is terminated. The fund represents the amount of fees JHU/APL has accumulated after paying non-reimbursable expenses. The arrangement between the Navy and JHU/APL states that the liquid portion of the fund--that portion not invested in facilities--will accumulate until it reaches a goal of 4 months' operating capital, which was about \$26 million for fiscal year 1979. At this point, the fee would be reduced. As of its fiscal year 1979 accounting period, JHU/APL had accumulated about \$18 million in the liquid portion of the fund.

The arrangement to provide JHU/APL with a stabilization and contingency fund is longstanding between the Navy and JHU/APL. However, according to Navy officials, the JHU/APL fund has never reached the 4-month goal. At the time of our review, the fund was about \$8 million short of its goal.

We identified two major factors which contributed to this short-fall. The first factor is that the earnings on the contingency capital do not accrue nor are they applied to the operations for which the fees were paid. Instead, the trustees transfer these earnings to the university's general fund. Income earned on the university's endowment investment pool represented a 6.3-percent yield in 1979, or over \$1 million earned on the \$18 million in the liquid portion of the fund. The second factor affecting the contingency goal is that by the end of fiscal year 1979, the trustees had transferred over \$8 million from this fund to acquire facilities.

### Facility needs

Both JHU/APL and MITRE have used their general support capital to purchase facilities. The Bell report stated that, where facilities are required to perform work desired by the Government, the Government should either provide the facilities or cover their cost as part of the contract. In this way, a sponsoring agency

would directly provide facilities needed for its contracts and be able to minimize the Government's costs.

While fees may be a practicable alternative for financing facilities, we do not believe that, as a rule, this would support accumulated reserves until a real need is identified and all possible alternatives are explored. Accumulating reserves requires the Government to pay carrying costs (the cost of borrowing this money) until an actual need is identified. Also, it presupposes that a fee is the best alternative for financing such facilities and may actually encourage the purchase of facilities with fees.

### CONCLUSIONS

The fee rates historically paid to JHU/APL, MITRE, and IDA are more than adequate to cover nonreimbursable expenses. Furthermore, we believe the working capital provided from the excess fees as of fiscal year 1979 exceeds amounts needed to cover operating expenses for one cycle. We also believe JHU/APL has demonstrated that advance payment arrangements are a workable method to keep working capital requirements to a minimum.

In 1969 we reported that DOD-sponsored nonprofit organizations did not need to accumulate fees to cover liabilities arising from contract termination because the agencies could mitigate the impact of termination by contractual provisions. We believe the Air Force has demonstrated that this is a workable method of meeting the contingency needs of these organizations. Because the need for termination insurance, may be met through contractual provision, which do not require an actual outlay of funds, we question the accumulation of working capital at each contractor to satisfy this need.

Of the \$30 million in working capital accumulated by the three organizations, we estimated that approximately \$18 million exceeded operational expense requirements. At a conservative estimate of 10-percent interest a year, the \$18 million in reserves could cost the Government about \$2 million a year to carry. This will become even more costly as these organizations continue to build reserves beyond these levels.

Furthermore, it is not clear that accumulating contingency capital is an effective way of protecting an organization in case the contract is terminated. We observed that the JHU/APL fund was about \$8 million short, and according to Navy officials, the fund had never reached its goal.

### CHAPTER 3

#### AGENCY PROCEDURES FOR DETERMINING FEES AT VARIANCE WITH FEE PURPOSE

Implicit in the historical basis for paying fees to Government-sponsored nonprofit organizations (to provide stability and cover certain nonreimbursable expenses) is the assumption that fees are provided for explicit needs. However, most Federal agencies that sponsor nonprofit organizations do not determine fees for these organizations based on an evaluation of the specific needs. The four Federal agencies that we reviewed use weighted guidelines, negotiated fee schedules, management allowances, and needs criteria to determine fees.

#### WEIGHTED GUIDELINES

The fees paid to JHU/APL, MITRE, and IDA were based on DOD's weighted guideline approach. DOD claims that weighted guidelines are intended to establish fee objectives that will stimulate efficient contract performance and attract the best capabilities of nonprofit organizations. In response to our 1969 report, DOD stated that the weighted guidelines for sponsored and nonsponsored nonprofit organizations were specifically adopted to offset some of the weaknesses of the needs approach. DOD's primary objection was that the needs-for-fee approach failed to recognize merit, excellence of effort, past achievements, quality of effort, and other such subjective factors.

Weighted guidelines establish fees by identifying factors, such as costs and contractor risk, which contracting officers are to consider in negotiating fees. In addition, the guidelines provide specific weight ranges which contracting officers may subjectively apply to the factors to determine fees. They also provide special negative factors for all nonprofit organizations as adjustments for Federal income taxation and for the continuing financial support provided by sponsoring agencies (see app. III).

Although the DOD weighted guidelines for nonprofit organizations were adopted to stimulate and reward performance, in practice, both civil and DOD agencies use such guidelines to justify the fee historically paid to several defense-sponsored nonprofit organizations. For example, the Navy uses weighted guidelines to justify a 3.4-percent fee it has been paying JHU/APL since at least 1974. By assigning minimum weights, the Navy calculated a 4.8-percent fee which was higher than the historical rate JHU/APL proposed, therefore the 3.4-percent fee was readily accepted. In another example, IDA has been receiving a 4.25-percent fee for a number of years. This fee was also readily accepted because the amount determined using the low to mid range weights of the weighted guidelines resulted in a higher fee of about 7 percent.

MITRE has typically received a fee of about 6 percent from agencies other than the Air Force and 3.5 percent from its sponsor. In each case, the various Federal agencies use their own versions of weighted guidelines to derive the fee objective. Specific versions differed on factors to be included and weight ranges to be applied. However, in almost every case the results support the 6-percent fee typically received by MITRE.

#### NEGOTIATED FEE SCHEDULES

The National Aeronautics and Space Administration contracts with a university, which in turn manages the agency-sponsored laboratory similar to the arrangement at JHU/APL. The fee paid to the university is based on a negotiated fee schedule. The scheduled rate declines as the estimated contract costs increase.

A National Aeronautics and Space Administration official indicated that the fee schedule provided for in the administration's procurement regulations was not determined based on explicit need but was considered reasonable compensation to the university for its role in administering the laboratory. The rates paid in fiscal year 1979 were less than 2 percent. We did not examine the need for the fee paid by the National Aeronautics and Space Administration.

#### MANAGEMENT ALLOWANCE

The Department of Energy authorizes a management allowance for university contractors operating its Government-owned laboratories. While the Department does not normally pay fees under contracts with educational institutions, it does permit management allowances to be paid to university contractors that operate large Government-owned laboratories. These allowances are similar to fees in that they are used to cover certain limited, estimated indirect (overhead) costs. The amount, however, is limited to whichever is lower--the university's estimate of properly allowable overhead or the Department's negotiated maximum fee schedule amount (about 1 percent). Furthermore, the allowance must be used for the types of indirect expenses that are agreed upon and that are audited. Where the allowance exceeds actual expenditures, the difference is applied to offset the next year's allowance. This allowance more nearly resembles the perception of fees held by NSF rather than by DOD.

#### NSF BASES FEES ON NEED

NSF follows a needs-for-fee methodology and contracts with nonprofit organizations to operate, manage, and maintain its research centers. The fees, which are usually less than 2 percent of the contract's cost, are included as line items in the centers' budgets and are accordingly scrutinized by the Congress. NSF fees are used to pay reasonable corporate expenses estimated to be incurred by the managing corporation during the 5-year life of the

contract and to accumulate a reserve equivalent of up to 2 years of corporate (overhead) operating expenses. Although the contract is for 5 years, the fees are subject to renegotiation by either party.

NSF closely monitors center expenditures from fees and reviews and compares requests with actual historical expenditures to determine if requests are reasonable. The managing corporations voluntarily submit fee expense summaries as part of the centers' yearly financial statements. On occasion, NSF has requested and has received detailed explanations of expenditures. As with the negotiated fee schedule, we did not examine the needs criteria used by NSF; therefore, we do not know whether the fees are excessive to the purposes for which fees are intended. Nevertheless, on the basis of our analysis of the three DOD-sponsored organizations, we are sceptical of the need for reserves equivalent to 2 years of corporate operating expenses. In response to our draft report, NSF said it was looking into this and that presently no reserves equaled more than one year's operating expenses.

#### CONCLUSIONS

The variety of procedures used to determine and pay fees to Government-sponsored nonprofit organizations reflects a lack of uniformity in Federal policy toward Government-sponsored nonprofit organizations. Furthermore, while some fees are determined based on identifiable needs, others are not. Because Government-sponsored nonprofit organizations do not have the independent relationship with their Federal sponsor that is normally presumed to exist in negotiations between the Government and contractors, we believe it is more appropriate to determine fees based on the objective and identifiable needs which will provide stability and cover legitimate nonreimbursable costs. We therefore believe weighted guidelines, which use subjective factors related to performance, are not appropriate to establishing fees for sponsored nonprofit organizations.

Furthermore, it is questionable that weighted guidelines are even accomplishing the things DOD wished to stress--for example, excellence of effort and merit. In practice, the three organizations were simply being awarded a historical rate, which was considered reasonable by DOD sponsors, because it was lower than the rate determined using the subjective guidelines. In addition, the higher rate was determined using medium to low weights, those associated with poor performance, not excellence.

## CHAPTER 4

### FEE GUIDANCE IS STILL NEEDED

Various agency methods used to determine fees for Government-sponsored organizations and varying fee rates are the result of the lack of Government-wide guidelines addressing Government-sponsored nonprofit organizations as unique organizations whose needs are distinct from other nonprofit organizations. In 1969 we recommended that the Office of Management and Budget, then known as the Bureau of the Budget, prescribe Government-wide guidelines that would limit the fees to the amount needed to provide operational stability and cover certain nonreimbursable expenses. The Office of Management and Budget deferred taking action pending the findings and recommendations of the Commission on Government Procurement. The Commission's report, issued in 1972, recommended that guidance be provided for the establishment, use, periodic review, and termination of FFRDCs. The report did not, however, address fee policy.

### DEFENSE ACQUISITION REGULATION AND FEDERAL PROCUREMENT REGULATION DO NOT BASE FEES ON NEED

Since no Government-wide guidelines exist regarding fee negotiations with Government-sponsored nonprofit organizations, Federal agencies use either DAR or FPR. Neither DAR nor FPR contains a specific fee objective strategy for Government-sponsored nonprofit organizations, although DAR does include an additional fee reduction to reflect the relatively low risk incurred by sponsored-nonprofit organizations and their tax-exempt status. Both sets of regulations are generally applied to profit and nonprofit organizations. Neither regulation was designed to specifically determine fees to provide operational stability and cover nonreimbursable expenses.

#### Defense Acquisition Regulation

DAR weighted guidelines were originally intended to be used for commercial contracts. However, when DAR was revised in 1966, a provision was incorporated to yield fee objectives for sponsored and independent nonprofit organizations. For nonprofit organizations, in general, a special "minus 3-percent" factor was included to reduce fees to offset their tax-exempt status. An additional "zero- to minus 1-percent" risk factor supplements the minus 3-percent factor for sponsored organizations.

DAR emphasizes profit or reward to the owners of a business as the stimulant for efficient contract performance. This method for determining a fee objective gives weight to merit and contractor effort. DAR's performance-based weighted guidelines, which replaced DOD's diverse fee methods, run counter to the underlying philosophy which spawned Government-sponsored nonprofit organizations--they were conceived as an instrument to perform

Government work. Therefore, they are insulated from the traditional market pressures that confront commercial and independent nonprofit organizations. Their tasks are public interest oriented and their fee needs are not construed as profit. The Government-sponsored nonprofit organization fees, which are narrowly defined and are subject to broad interpretation, help the organizations achieve Government-related objectives. This difference in philosophy is fundamental to understanding why DAR does not adequately address fees paid to these organizations.

#### Federal Procurement Regulation

FPR does not differentiate between nonprofit organizations, which are tax exempt, and commercial concerns. FPR makes the cognizant procurement officials responsible for judging the extent to which fees will be based on contractor needs. The only guidance FPR provides is the stipulation that agency contracting officials, when determining profit/fee objectives, are to consider the

- effect of competition,
- degree of risk,
- work to be performed,
- extent of Government assistance,
- extent of contractor investment,
- character of contractor's business,
- contractor's performance,
- subcontracting, and
- unrealistic estimates.

These factors, applicable to all cost reimbursement type contracts, are incorporated into a narrative guideline, which is used by a contracting officer to establish a fee as a dollar amount. To comply with the statutory fee limitations--15 percent for cost-plus-fixed-fee research and development contracts and 10 percent for all other cost-plus-fixed-fee contracts--it is necessary to determine the percentage relationship between contract cost and fee amount.

This broad framework does not provide a negative fee adjustment for cost reimbursement contracts awarded to nonprofit organizations. In addition, FPR fails to recognize or identify Government-sponsored nonprofit organization needs as the appropriate basis for fee determination. Furthermore, since FPR is general, it does not highlight the differences among commercial, independent nonprofit and Government-sponsored nonprofit

organizations. Agencies must devise or adopt their own methods of adjustment.

#### WHAT IS BEING DONE?

In response to the Commission on Government Procurement's recommendation, the Office of Federal Procurement Policy developed uniform profit and fee guidelines for all negotiated contracts requiring cost analysis. In addition, it issued a policy letter in December 1980, which directs each agency to adopt a structured approach for determining profit/fee objectives. The directive instructs agencies to implement weighted guidelines and states that agencies can develop their own methods if they "incorporate logic and rationale similar to those of weighted guidelines." It also instructs agencies to incorporate a set of common profit factors into their cost-analysis approach.

#### Proposed policy letter on FFRDCs

The Office of Federal Procurement Policy has recently solicited comments on a proposal that would establish uniform guidelines for the establishment, use, periodic review, and termination of FFRDCs. In addition, the proposal addresses special factors, including risk and the use of Government-furnished property and facilities, that affect fee negotiations. However, the proposal does not mention uniform FFRDCs fee guidelines.

#### CONCLUSIONS

In 1969, because fees were not being used as intended and because of the diversity of methods and rates in existence, we recommended that the Office of Management and Budget, then known as the Bureau of the Budget, prescribe Government-wide guidelines for Government-sponsored nonprofit organizations. The recommended guidelines were to limit fees to the amount needed to provide operational stability and cover certain nonreimbursable costs. To date, no such guidance has been promulgated. Federal agencies get their guidance from DAR and FPR and neither provide for fees based on nonreimbursable cost and operational stability.

During this review, we found Federal agencies continuing to use a variety of procedures to determine fees for sponsored nonprofit organizations. Procedures ranging from needs-based criteria to subjective assessments of performance resulted in fee rates ranging from less than 1 percent to over 4 percent.

Our assessment of three DOD-sponsored organizations showed that their fees exceeded levels needed to cover nonreimbursable expenses and reserves for normal operations (working capital). The excess fees which were added to corporate capital were justified to cover liabilities that could arise if the contracts were terminated or not renewed and to provide for new facilities if needed.



Because the Air Force has demonstrated that termination contingencies may be provided for within the terms of the contract, we question the need to accumulate such reserves. Furthermore, we do not believe it is clear that such accumulations would be effective in meeting termination expenses should they arise. Navy officials said that JHU/APL has never reached the goal set for its stabilization and contingency fund.

Thus, based on our current review, we believe our 1969 recommendation is still valid. Furthermore, as part of such guidelines, we also believe the Office of Federal Procurement Policy should consider how agencies may best provide for termination and nonrenewal contingencies. The Office has solicited comments on a proposal that would establish guidelines for the establishment, use, periodic review, and termination of FFRDCs. We believe this may also be a good vehicle for fee guidance.

## CHAPTER 5

### AGENCY AND CONTRACTOR COMMENTS AND OUR EVALUATION

We received written comments from the National Aeronautics and Space Administration, NSF, the Department of Energy, and DOD. (See apps. V, VI, VII, and XI.) The Office of Management and Budget did not provide comments. We also received comments from MITRE, JHU/APL, and IDA. (See apps. VIII, IX, and X.)

### AGENCY COMMENTS AND OUR EVALUATION

The four Federal agencies commenting generally supported, or did not object to, the recommendation that the Office of Federal Procurement Policy establish criteria for fee negotiations with Government-sponsored nonprofit organizations. However, they stressed the need for flexibility. In addition, DOD stated that while it did not object to the recommendation, neither does it believe it is necessary or cost effective for its purposes. We believe the agencies' concerns over the need for flexible guidelines are reasonable in view of the diversity of the organizational arrangements and missions of Government-sponsored nonprofit organizations. We also believe, because of the sponsoring relationship, that flexibility should exist within a needs framework. Furthermore, we believe our recommendation is applicable to all agencies sponsoring nonprofit organizations.

#### The National Aeronautics and Space Administration

The National Aeronautics and Space Administration said that, because our scope was limited, we reached broad conclusions about the "need-for-fee" criteria. It is correct that we restricted our review of specific Government-sponsored nonprofit organizations to three DOD contractors. However, the needs basis for fees is well documented in the Bell study, congressional hearings on the Aerospace Corporation, and an Air Force study. In all cases, background material identifies needs as the justification for fees for Government-sponsored nonprofit organizations. Furthermore, we found no studies which recommended other than needs as a basis for fees to Government-sponsored nonprofit organizations.

The National Aeronautics and Space Administration also stated that it is unclear from the draft report that our recommended criteria for fee determination based on need will, in fact, produce fees which we consider to be reasonable. We are not suggesting that we would set such standards, we are concluding that the need for the Office of Federal Procurement Policy to establish uniform guidance so that agencies sponsoring nonprofit organizations may better recognize the legitimate needs of these organizations and know under what circumstances fees would be more appropriate for meeting the organizations' needs still exists.

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## DOD

DOD believes we have based our conclusions on two erroneous assumptions. DOD believes we assumed that fees are not needed to accumulate reserves for acquisition of facilities because it is more economical for the Government to provide the facilities. It also believes we assumed that fees are not needed to accumulate reserves for the contract termination contingency because it could be accommodated more economically by other means, such as through special termination cost clauses in the contract. We address this second issue in our response to MITRE's comments.

Concerning accumulated capital to acquire facilities, our point is that the justification is a general one. This justification supports the general accumulation of capital resulting from the payment of historical rates determined through the application of weighted guidelines. We point out in our report that JHU/APL's stabilization and contingency fund can be used by trustees at their discretion to obtain facilities.

We also said that the Bell study provided guidance that stated that the Government should provide facilities, either directly or indirectly, through the contract. We do not assume, as DOD has indicated, that in each case it is more economical for the Government to provide facilities. However, we do believe that reserves accumulated from the payment of historical fee rates and justified on the general basis that they will be needed sometime in the future are biased toward accumulating fees for facilities and may not be the most economical way for the Government to provide for these needs. They are idle funds for which the Government must continue to pay interest.

DOD further states that its weighted guidelines are "tempered" with a critical evaluation of the needs for capital accumulation. While we did observe that fee rates were reduced by factors relating to capital accumulation, the adjustment, however, was used to bring the weighted guidelines rate down to the historical fee rate. We found no indication that needs dictated the adjustment factor other than to increase the fee.

## Department of Energy

The Department stated:

"The CAO draft report findings are solely related to DOD's system analysis and system engineering centers which constitute only two of the various types of FFRDCs. While the report recommendations may logically flow from the findings regarding DOD's FFRDCs they are not related to and in our view should not be applied indiscriminately to all FFRDCs."

While our review of the use of fees was limited to three DOD-sponsored nonprofit organizations, this was only one factor leading us to continue to support our 1969 recommendation.

The sponsoring relationship between the Government and sponsored nonprofit contractors is a unique one. It cannot be presumed that fees will be negotiated with the independence that may normally be present in other contracting situations. Thus, we believe fees based on the objective determination of certain recognized needs continues to be valid.

We also observed that the current procurement guidance provided by FPR and DAR is general and does not recognize nonreimbursable expenses and operational stability as a basis for paying fees to sponsored organizations as recommended in our 1969 report. The resulting methods developed by Federal agencies continue to vary ranging from needs-based criteria to subjective appraisals of quality and performance. Furthermore, the fee rates resulting from the various methods range from less than 1 percent to over 4 percent.

Based on the above and the questions raised concerning the economy and effectiveness of providing fees to cover termination and nonrenewal costs raised from our review of DOD-sponsored nonprofit organizations, we believe our 1969 recommendation is still valid.

#### CONTRACTOR COMMENTS AND OUR EVALUATION

The three nonprofit organizations generally believed their fees were reasonable and necessary. We believe that fees may not be the best way for the Government to meet certain of these organizations' needs.

#### MITRE

MITRE stated "we see no evidence or even supporting argument in the report that the GAO draft proposals would be more economical, let alone as effective as current practice." First, we should point out that current practices between MITRE and the Air Force are not the same as current practices between other Federal agencies and their sponsored organizations or between other Federal agencies and MITRE.

We acknowledge that our examination did not include a comparative cost analysis of alternatives to fees. However, we provide evidence that strongly suggests that certain needs may be more economically and effectively met through provisions in the contract than through capital accumulated from fees. For example, we found that under current practices, the three organizations were accumulating reserves above amounts supported by working capital needs and after providing for all nonreimbursable expenses and facilities.

The justification for providing fees sufficient to accumulate such reserves was the potential need for capital expansion and contract termination insurance. Although such needs may well be valid for Government-sponsored organizations, it does not seem reasonable for the Government to pay millions of dollars for a contingency that may never occur nor does it make sense to fund accumulated reserves until a decision is made for capital expansion. In support, we also found that the Air Force, in past contracts with MITRE, had provided for termination and nonrenewal contingencies through contractual provisions, rather than through fees.

Air Force contracting officials believed this was more economical than establishing a reserve with increased fees. Furthermore, we learned from Navy officials that the reserve for termination and nonrenewal at JHU/APL had never reached the goal set for it. Thus, while we cannot say that this alternative is the most economical, we do believe our observations raise serious questions about the economy and effectiveness of providing such reserves and support our conclusion that guidance is needed in that area.

#### IDA

IDA stated that the requirement for liquid asset reserves depends on the maximum, rather than the average, days in the operating cycle. IDA is partially correct. Actually, the requirement for working capital is based on the timing of both receivables and payables. Even if the Government did not pay IDA for 62 days, as cited in its example, there would be a problem only if its expenses during that period exceeded the amount in reserve. The formula we used is one method of bringing into focus the adequacy of such reserve amounts and considers both income and expenses. In our opinion, IDA may wish to consider JHU/APL's arrangement with the Navy as a way to minimize its working capital requirements.

IDA also believed our report did not adequately address all the needs. Our approach was not to pass judgment on the variety of nonreimbursable expenses, but to assess the appropriateness of accumulating reserves.

#### JHU/APL

JHU/APL said its fee was based on need and was modest by any standards. We acknowledge that fees are paid in recognition of needs. Our point is that in certain instances fees may not be the best way to provide for certain needs. For example, we pointed out that some contingencies can be provided for in contracts. Furthermore, whether or not the fee is modest depends on whether (1) the needs were legitimate, (2) fees were the best way to meet the needs, and (3) the actual fee paid exceeded the needs.

It is also important to note that JHU/APL's explanation of its fee rate does not include the income accruing to the university (over \$1 million a year) from the stabilization and contingency fund which JHU/APL believes is the only "significant" income accruing to the university for managing and supporting the mission of the laboratory. It qualifies income with the term significant because the nonreimbursable expenses paid for out of the fee also include an amount for university management.

Finally, JHU/APL states that we are incorrect in including it as an FFRDC and that its contractual relationship does not involve sponsorship in the sense of a budget line item or other guaranteed support. JHU/APL is correct that it is no longer classified by NSF as an FFRDC. However, we believe its relationship with the Navy is indicative of a Government-sponsored non-profit organization and has many of the characteristics of an FFRDC. First, JHU/APL and the Navy have a trust agreement concerning the disposition of facilities. Second, it has a 5-year contract with the Navy. Third, other agencies contracting with JHU/APL go through the Navy contract and reimburse the Navy. Fourth, JHU/APL has committed its assets to the Navy as long as the need exists. Finally, we believe it is the sponsoring relationship between the two parties which justifies any obligation on the part of the Navy to cover termination costs should the contract not be renewed.



## APPENDIX I

## APPENDIX I

## SCHEDULES OF FISCAL YEAR 1979 COSTS-PLUS-FEE-TYPE CONTRACTS OVER \$10,000 (note a)

## WITH GOVERNMENT-SPONSORED NONPROFIT ORGANIZATIONS

## BY FEDERAL AGENCY

	Civil agencies	DOD agencies	Total
	----- (000 omitted) -----		
<u>DOD:</u>			
Office of the Secretary of Defense:			
Administered by independent nonprofit organizations:			
Institute for Defense Analysis	\$ 238	\$ 15,330	\$ 15,568
Department of the Navy:			
Administered by universities:			
Center for Naval Analysis (University of Rochester)	-	-	-
JHU/APL (note b)	33	155,099	155,132
Department of the Air Force:			
Administered by independent nonprofit organizations:			
Aerospace Corporation	9,898	130,334	140,232
MITRE Corporation (Metrer/C3 Division)	18,388	84,643	103,031
Project Air Force (Rand Corporation)	2,405	18,315	20,720
Administered by universities:			
Lincoln Laboratory (MIT), Massachusetts	169	-	169
Institute of Technology			
<u>Department of Energy:</u>			
Administered by independent nonprofit organizations:			
Pacific Northwest Laboratory (Battelle Memorial Institute)	27,809	-	27,809
Solar Energy Research Institute (Midwest Research Institute)	85,591	-	85,591
Administered by universities:			
Iowa State University of Science and Technology:			
Ames Laboratory	-	-	-
University of Chicago & Argonne Univ.'s Assoc:	-	-	-
Argonne National Laboratory	-	-	-
Association of Universities Ins. (Also see NSF)	-	-	-
Brookhaven National Laboratory	-	230	230
University of California:			
Lawrence Berkley Laboratory	518,254	-	518,254
Lawrence Livermore	-	-	-
Los Alamos Scientific Laboratory	24,692	-	24,692
Universities Research Assoc., Inc.	-	-	-
Fermilab			
Oak Ridge Associated Universities:			
Oak Ridge Institute of Nuclear Studies	-	-	-
Princeton University:			
Plasma Physics Laboratory	-	50	50
Stanford University:			
Stanford Linear Accelerator Center	-	49	49

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	<u>Civil agencies</u>	<u>DOD agencies</u>	<u>Total</u>
	----- (000 omitted) -----		
<u>National Aeronautics and Space Administration:</u>			
Administered by universities:			
California Institute of Technology:			
Jet Propulsion Laboratory	333,801	-	333,801
<u>NSF:</u>			
Administered by universities:			
Association of Univ. for Research in			
Astronomy, Inc.:			
Cerro Tololo Inter-American	9,441	-	9,441
Kitt Peak National Observatory			
Sacramento Peak Observatory			
Cornell University:			
National Astronomy and Ionosphere			
Center	-	-	-
University Corporation for Atmospheric			
Research:			
National Center for Atmospheric			
Research	28,858	-	28,858
Association of Universities, Inc.			
(Also see the Department of Energy):			
National Radio Astronomy	19,460	-	19,460
Total	<u>\$1,079,037</u>	<u>\$404,050</u>	<u>\$1,483,087</u>

a/These amounts represent contracts over \$10,000, as reported by Federal agencies to the Federal Procurement Data System and, therefore, would not include all amounts.

b/JHU/APL has characteristics of FFRDCs but chooses not to call itself one.

Note: In most cases, where sponsored organizations are administered by universities, amounts are shown across from the university.

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Solar Energy Research Institute (Midwest Research Institute)	85,591	-	85,591
Administered by universities:			
Iowa State University of Science and Technology:			
Ames Laboratory	-	-	-
University of Chicago & Argonne Univ.'s Assoc:	-	-	-
Argonne National Laboratory	-	-	-
Association of Universities Ins. (Also see NSF)	-	-	-
Brookhaven National Laboratory	-	230	230
University of California:			
Lawrence Berkley Laboratory	518,254	-	518,254
Lawrence Livermore	-	-	-
Los Alamos Scientific Laboratory	24,692	-	24,692
Universities Research Assoc., Inc.	-	-	-
Fermilab	-	-	-
Oak Ridge Associated Universities:			
Oak Ridge Institute of Nuclear Studies	-	-	-
Princeton University:			
Plasma Physics Laboratory	-	50	50
Stanford University:			
Stanford Linear Accelerator Center	-	49	49

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	<u>Civil agencies</u>	<u>DOD agencies</u>	<u>Total</u>
	----- (000 omitted) -----		
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Administered by universities:			
California Institute of Technology:			
Jet Propulsion Laboratory	333,801	-	333,801
<u>NSF:</u>			
Administered by universities:			
Association of Univ. for Research in Astronomy, Inc.:			
Cerro Tololo Inter-American	9,441	-	9,441
Kitt Peak National Observatory			
Sacramento Peak Observatory			
Cornell University:			
National Astronomy and Ionosphere Center	-	-	-
University Corporation for Atmospheric Research:			
National Center for Atmospheric Research	28,858	-	28,858
Association of Universities, Inc. (Also see the Department of Energy):			
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CHRONOLOGY OF FFRDC FEE RELATED EVENTS

Prior to 1949	DOD did not pay fees to nonprofit organizations.
1949	Several nonprofit DOD contractors asked for fees to support organizational stability, capital investment, and independent research.
1949-51	Although no DOD-wide policy had been established, most military contracts authorized fees ranging from 2 to 6 percent.
1951	A triservice military committee set a 6-percent fee ceiling for nonprofit organizations, sponsored and nonsponsored. The 6-percent fee became standard on most contracts regardless of previous fees paid.
1958	The Committee on Armed Service Procurement Regulations (ASPR) rejected the 6-percent fee concept. Each contract would be based on merit. Tradition died hard, however, as the flat fee continued to influence policy.
1961	An Air Force policy statement directed that fees paid to nonprofit organizations were to be based on needs.
1961	The National Aeronautics and Space Administration began paying the California Institute of Technology a fee for operating the Jet Propulsion Laboratory, an FFRDC. The National Aeronautics and Space Administration based the fee on complexity of work and risk. The National Aeronautics and Space Administration does not consider need when determining the fee.
1962	A memorandum from the Deputy Secretary of Defense to the Secretary of the Air Force ruled out flat fees. An excerpt from the memorandum stated "The fee should be negotiated and not treated by either party as <u>de facto</u> , a static or fixed percentage."

## APPENDIX II

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- 1962           The Bell report supported fee payments to not-for-profit organizations <sup>1/</sup> to provide operational stability and flexibility to conduct independent research.
- 1965           The Aerospace Corporation, an Air Force-sponsored FFRDC, was the subject of a report of the Subcommittee for Special Investigations, House Committee on Armed Services. The Subcommittee made it clear that Aerospace, which was wholly created and supported by the Government, was a public trust. As such, it must be accountable for the use of public funds, including fees. This premise supports the argument that fees should be based on legitimate organizational needs.
- 1965           The Congress put a ceiling on funds for DOD-sponsored FFRDCs. The Senate Committee on Armed Services justified the ceiling on the basis that FFRDCs weakened in-house competence.
- 1965           The Johnson-O'Neill Committee report--also known as the Air Force Ad Hoc Group Study--recommended that MITRE's and Aerospace's fees be based on need. However, their fees should not be allowed to accumulate beyond the point which would enable the organizations to become financially independent.
- 1966           The Deputy Secretary of Defense approved a modification to weighted guidelines for computing fees on contracts with nonprofit organizations.
- 1966           DOD issued modified weighted guidelines for nonprofit organizations. The guidelines set a minus 3-percent factor to reduce fees for these organizations. An additional 1 to 2 percentage point reduction was included for FFRDCs. The weighted guidelines use fee as a reward for efficient contract performance.
- 1966           The Secretary of the Air Force commented that the modified weighted guidelines should lead to "a fee substantially lower than present."

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<sup>1/</sup>The term "not-for-profit organization" is the same as nonsponsored nonprofit organization.

## APPENDIX II

## APPENDIX II

- 1966 A task force appointed by the Chairman, Defense Science Board, reported that management fees were the best way to ensure FFRDC independence.
- 1967 The Chairman of the House Committee on Appropriations stated that FFRDCs used fees "to expend funds for purposes for which reimbursement \* \* \* would not be allowed in the Federal Government."
- 1967 Our report found that fees paid by NSF to the National Center for Atmospheric Research, an FFRDC, were based on need. NSF's Director agreed with our suggestion that the size of an FFRDC's fee reserves should be considered when evaluating present fee requirements.
- 1969 Our report found that fees paid to sponsored nonprofit organizations varied among Government agencies and were rarely used to conduct independent research. We recommended that a Government-wide policy be established regarding the amount and use of fees received by FFRDCs.
- 1971 The House Committee on Appropriations, in its report on the DOD appropriations bill for fiscal year 1972, recommended that four FFRDCs--Rand Corporation, Research Analysis Corporation, Center for Naval Analyses, and the Institute for the Defense Analyses--have their funds reduced by approximately 25 percent. The Committee's rationale was that FFRDC "pruning" would force DOD to develop in-house analytical capabilities.
- 1971 We reported that fees paid to independent not-for-profit organizations were not significantly lower than fees paid to commercial concerns for similar work. We proposed that the Office of Management and Budget lead the way in developing guidelines governing the negotiations of fees paid to not-for-profit and commercial organizations.
- 1972 The Commission on Government Procurement recommended that guidance be provided for the establishment, use, periodic review, and termination of FFRDCs. FFRDC fee policy was not addressed.

## APPENDIX II

## APPENDIX II

- 1976           The Office of Management and Budget directed that salaries in excess of \$45,000, paid to executives of not-for-profit corporations, were chargeable to fees.
- 1976           DOD's weighted guidelines were revised to recognize a new cost factor, imputed interest of facilities investment, which accounted for 10 percent of the average profit objective.' In response to this addition and to other changes to weight mix and weight ranges, DOD reduced the minus 3 percent to minus 1 percent for nonprofit organizations. The supplemental negative adjustment for FFRDCs was also decreased.
- 1979           The Air Force raised its fee to MITRE from the historically negotiated rate of 3.5 percent to 4 percent. The increase was based on MITRE's capital investment related to facilities expansion.
- 1980           DOD's weighted guidelines were revised to provide uniform profit procedures for labor-intensive contracts, primarily research and development and services contracts, where few facilities are required for performance. For those organizations which perform research and development work, the weighted guidelines returned the special minus 3-percent fee reduction factor. The additional negative adjustment for FFRDCs was unchanged.
- 1980           The Federal Register solicited comments on an Office of Federal Procurement Policy proposal concerning FFRDC establishment, use, and termination provisions. This proposal considered risk, among other factors, as a special factor which affects FFRDC fee negotiations.
- 1980           An Office of Federal Procurement Policy directive instructed executive agencies to adopt a structured approach for determining profit and fee objectives. It encourages agencies to use weighted guidelines. The directive does not address fee negotiations with FFRDCs.
- 1980           The Air Force raised MITRE's fee to 5 percent under the terms of a firm fixed-price, level of effort contract.



1981

The University Corporation for Atmospheric Research, which contracts with NSF to operate the National Center for Atmospheric Research, indicated it no longer wants to have its fee based solely on need.

DOD WEIGHT RANGES FOR RESEARCH AND DEVELOPMENT CONTRACTS

A. Contractor effort:	
Material acquisition	
Subcontract items	1 to 5 percent
Purchased parts	1 to 4 percent
Other material	1 to 4 percent
Engineering	
Direct labor	9 to 15 percent
Manufacturing	
Direct labor	5 to 9 percent
Services	
Direct labor	N/A
Overhead	N/A
Other	
General management	6 to 8 percent
B. Contractor risk	-1 to 0 percent
C. Facilities investment	N/A
D. Special factors	
Productivity	N/A
Independent development	1 to 4 percent
Other	-5 to +5 percent
Nonprofit	-3 percent

Source: DAR (ASPR) 3-808.4 @, (c-2i,ii)

SUMMARY OF REQUEST

We agreed with Senator Baucus' staff that our review would focus on Government-sponsored nonprofit organization and that we would address the following questions.

1. Are nonprofit corporations with Federal contracts being paid Federal monies above the cost of such contracts?

Answer: Yes. (See p. 1.)

2. If so, how are these monies justified?

Answer: The historical justification is need. These organizations have certain financial requirements not reimbursable under current cost-reimbursement regulations. (See p. 4.)

3. Should these organizations receive fees?

Answer: A fee is one option available to the Government to address the financial needs of these organizations. (See p. 4.)

4. How extensive is the practice in terms of agencies' dollars involved and nonprofit organizations?

Answer: Based on information obtained through the Federal Procurement Data System, the use of cost-plus-fixed-fee contracts with nonprofits is concentrated in the federally sponsored nonprofit organizations. (See p. 1.)

5. Do nonprofit corporations, largely dependent on Federal work, maintain surplus capital above their monetary needs?

Answer: The organizations we reviewed do maintain surplus capital, which they believe is needed. However, our review identified alternative and potentially less costly ways that the Government could satisfy these needs. (See ch. 2.)



National Aeronautics and  
Space Administration

Washington, D C  
20546

Reply to Attn of L

DEC 5 1 1981

Mr. W. H. Sheley  
Director  
Mission Analysis and Systems  
Acquisition Division  
441 G Street, N.W.  
Washington, DC 20548

Dear Mr. Sheley:

Thank you for the opportunity to review GAO's draft report entitled, "Guidelines for Fees are Required to More Economically and Efficiently Satisfy Needs of Government Sponsored Nonprofit Organizations," Code 950642.

Although we partially concur with the GAO draft recommendation, some of the report's conclusions are very broad based on the limited scope of the review. Our more specific comments are enclosed.

Sincerely,

A handwritten signature in cursive script, appearing to read "Russell Ritchie".

Russell Ritchie  
Deputy Associate Administrator  
for External Relations

Enclosure

NASA comments on GAO Draft Report:

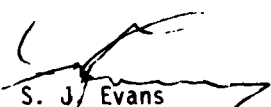
Guidelines for Fees are Required to More Economically  
and Efficiently Satisfy Needs of Government Sponsored  
Nonprofit Organizations (950642, December 2, 1981)

The General Accounting Office reviewed fees paid to three Department of Defense sponsored Federally Funded Research and Development Centers (FFRDCs), the Institute for Defense Analysis, the MITRE Corporation, and the Johns Hopkins University Applied Physics Laboratory, and concluded that the fees paid to these organizations should be based on need. NASA's Jet Propulsion Laboratory, operated by the California Institute of Technology, and the Space Telescope Institute contract with the Association of Universities for Research in Astronomy Inc., while not actually part of the GAO review, were discussed in the draft report.

The scope of the GAO review, while limited, reached very broad conclusions. For example, it is considered that GAO has not conclusively demonstrated that need is the only appropriate criterion for determining fees to FFRDCs. We also question the appropriateness of the draft's conclusion that NASA fees for an FFRDC "may be excessive" (p. 20), absent empirical findings to support that view. In addition, it is unclear from the draft report that the GAO-recommended criteria for fee determination based on need will in fact produce fees considered reasonable by GAO standards. The National Science Foundation, for instance, was the only agency identified as using a needs-for-fee methodology (p. 17). However, the draft report then goes on to state that "... we do not know whether the fees are excessive to the purposes for which fees are intended" (p. 21).

With respect to statements in the draft report referencing NASA contracts, it is suggested that the discussion of the Jet Propulsion Laboratory fee schedules (p. 20) and the weighted guidelines approach relative to the Space Science Institute contract fee (p. 26) be clarified. NASA Procurement Regulation 3.808 provides guidance in determining profit/fee objectives by using a structured approach. Express exceptions to the structured approach include management contracts for operation and/or maintenance of Government facilities and the negotiation of other contracts having unusual pricing situations. The fees for both the Jet Propulsion Laboratory contract and the Space Science Institute contract were negotiated within the purview of these exceptions to the structured approach.

Finally, we partially concur in the GAO draft recommendation, to the extent that the Office of Federal Procurement Policy, in coordination with the Federal agencies, should establish criteria for determining profit/fee objectives for negotiation with Government sponsored nonprofit organizations. It is considered appropriate that these criteria be in the form of general guidelines affording agencies flexibility in the contracting process and recognition of the considerable diversity of organizational as well as financial arrangements for FFRDCs and the concomitant impact on risk, technical effort required, and quality of performance.

  
S. J. Evans  
Director of Procurement

NATIONAL SCIENCE FOUNDATION  
WASHINGTON D C 20550

DEC 28 1981

Mr. Morton Myers, Director  
Division of Program, Development and Analysis  
General Accounting Office  
441 G Street, N.W.  
Washington, D.C. 20548

Dear Mr. Myers:

We have reviewed the GAO Draft Report entitled "Guidelines for Fees Are Required to More Economically and Efficiently Satisfy Needs of Government-Sponsored Nonprofit Organizations" and essentially agree that there should be government-wide guidance for determining fees paid to Federally Funded Research and Development Center (FFRDC) contractors. We wish to emphasize however, that any such guidance should contain flexibility as discussed on page 26 of the report.

Specific comments follow:

- 1) On page 21, the report questions the appropriateness of NSF's policy to allow its center contractors to accumulate reserves equivalent to up to two years of corporate operating expenses. In this connection, the reserves discussed for the DOD-sponsored organizations are calculated on the basis of the costs of the total operation, and thus involves typically several million dollars per month. The reserves of NSF's center contractors are calculated only on the basis of annual corporate expenses of the management contractor, not on the costs associated with the entire operation of the center and therefore do not exceed 2% of the total cost per year of the operation of the center.

The NSF is in the process of reevaluating this policy. At this time no NSF center contractor has a reserve that is greater than one year's corporate operating expenses.

- 2) On page 25 and page 38 (Appendix II) the report indicates that the University Corporation for Atmospheric Research (UCAR) has requested that its corporate expenses be divided among the agencies it contracts with in addition to receiving a modest fee. GAO further indicates that "this request would alter NSF's rationale and approach in determining fees."

Actually, UCAR has requested that NSF consider changing the method for reimbursement of corporate expenses from direct to a G&A allowance in addition to requesting a modest fee. The G&A allowance would provide for appropriate allocation of corporation expenses among UCAR's "customers." NSF would continue to provide for corporate expenses on a "needs" basis.

- 3) Appendix I, page 30 shows that the Association of Universities for Research in Astronomy, Inc., received \$9,441,000 under its NSF contracts during FY1979. This figure should be \$17,400,000 which includes other agency funds in addition to NSF funds. Also, the amounts shown for UCAR and the Associated Universities, Inc., on page 31 should be revised to read "\$34,327,000" and "\$23,161,000" respectively. These amounts also include other agency funds in addition to NSF funds.
- 4) Appendix II, page 38, GAO states that UCAR is "sponsored by the NSF." UCAR is a private, non-profit corporate entity, not sponsored by the NSF. The National Center for Atmospheric Research (NCAR) is sponsored by NSF and operated under contract with UCAR.

Sincerely yours,



Jerome H. Fregeau, Director  
Office of Audit and Oversight



Department of Energy  
Washington, D.C. 20585

FEB - 8 1982

Mr. J. Dexter Peach  
Energy and Minerals Division  
U. S. General Accounting Office  
Washington, D. C. 20548

Dear Mr. Peach:

The Department of Energy (DOE) appreciates the opportunity to review and comment on the GAO draft report entitled "Fee Guidelines Are Required to More Economically and Efficiently Satisfy Needs of Government Sponsored Nonprofit Organizations." DOE believes that any sound Government-wide fee guidelines applicable to Federally Funded Research and Development Centers must recognize the inherent differences among the various types of such institutions and must provide the flexibility to address these differences as well as encompass a variety of procurement situations.

The Department does not agree with this draft GAO report's usage of the term "Federally Funded Research and Development Center (FFRDC)" when their review encompassed only Federal Contract Research Centers (FCRCs). FCRCs are the Department of Defense's (DOD) designation for "think tanks" and system analysis and engineering contractors established solely to service DOD. "FFRDC" is a term created by the National Science Foundation (NSF) for reporting purposes which does not have and was never meant to have any relationship to contracting procedures with these "centers."

The analysis and recommendations of the Commission on Government Procurement (COGP) relative to FFRDCs recognized that problems associated with FFRDCs are different for each type and that each type must be treated separately. In the COGP working papers on FFRDCs, they stated that, "the generally high quality of the work performed by FFRDCs of the operating laboratory type has never been questioned and the value of their work is universally acknowledged. Yet the criticism that has been leveled, rightly or wrongly, at the think-tank and systems management types has unfortunately rubbed off on the operating laboratories as well."

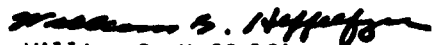


The COGP recognized that the vastly different types of FFRDCs require separate, not uniformly applied treatment. The GAO draft report's findings are solely related to DOD's systems analysis and systems engineering centers which constitute only two of the various types of FFRDCs. While the report's recommendations may logically flow from the findings regarding DOD's FFRDCs, they are not related to and, in our view, should not be applied indiscriminately to all FFRDCs. We suggest that GAO consider revising their recommendations so as to clearly differentiate among FFRDCs and ensure any such fee guidance recommended to be established by OFPP/OMB specifically provide for agency flexibility in application of the resulting guidance.

It should be noted that DOE does not award "fees" to educational institutions operating Government-owned laboratories which are listed by NSF as "FFRDCs". DOE Procurement Regulations (DOEPR 9-3.808-52) prohibit "fees" to educational institutions. However, since DOE's cost principles in this area are unique, DOE may chose to provide these educational institutions a "management allowance". This allowance is to cover certain central university indirect expenses expended in the course of the contract which are allowable under Federal Procurement Regulation (FPR) cost principles but not under DOE's principles.

Comments of an editorial nature have been provided directly to members of the GAO audit staff. DOE appreciates the opportunity to comment on this draft report and trusts that GAO will consider the comments in preparing the final report.

Sincerely,

  
William S. Heffelfinger  
Assistant Secretary  
Management and Administration

**MITRE**

23 December 1981

Mr. Donald J. Horan  
Director  
United States General Accounting Office  
Procurement, Logistics, and  
Readiness Division  
Washington, DC 20548

Dear Mr. Horan:

This will acknowledge receipt of the draft copy of GAO Report (Code 950642) entitled "Fee Guidelines are Required to More Economically and Efficiently Satisfy Needs of Government Sponsored Nonprofit Organizations." Thank you for this opportunity to comment on the draft report.

We agree that an appropriate fee is necessary for MITRE to operate as a healthy and effective organization and to provide efficiently the high quality of professional services that the Air Force and our other sponsors require. We believe, in fact, that over the last twenty-three years we have worked out with the Air Force through negotiations a most reasonable and economical way of determining fees. We see no evidence or even supporting argument in the report that the GAO draft proposals would be more economical, let alone as effective as current practice. We don't believe it would be wise to change a smooth working and effective arrangement developed over a long period of time, on the basis of unsubstantiated and perhaps unworkable alternatives.

The following comments are on parts of the draft report that are incorrect or not clear.

Page iii, paragraph 2 states: "Two of the three organizations claimed the additional reserves were necessary to protect them in the event of contract termination. ... For example, the contract between the United States Air Force and The MITRE Corporation provides for such a contingency within the terms of the contract rather than through fees".

This paragraph is in error as there is no clause in the contract that protects MITRE in the event of nonrenewal of the contract. MITRE also believes that it must build up reserves to the equivalent of three months' operating expenses to meet its obligations to employees in the event of nonrenewal of contracts.

The MITRE Corporation  
Burlington Road  
Bedford, Massachusetts 01730

Page 5, paragraph 2 states that one of the FFRDC's refused to provide its sponsor with the financial information it needed to determine fees. This happened in 1965 and the implication, although perhaps not intended, is that FFRDC's as a group are noncooperative in financial disclosures. Since its inception in 1958, MITRE has always maintained an open book policy. Its financial records on revenues and expenses including direct, indirect and fee related items are available for inspection by the Air Force, DCAA, GAO and any other official representative of the government.

Page 7, paragraph 1 states that DoD sponsors pay the FFRDC's fixed percentages of their reimbursable costs as a general level of financial support. This is inaccurate; in fact, such an arrangement is illegal. The cost reimbursable contracts between MITRE and the Air Force were classified as CPFF, cost plus fixed fee.

The report states on pages 7 and 8 that MITRE's working capital needs exceeded operating expense requirements by \$2,039,656. We are not certain how this figure was derived, but at any rate it represents less than one week's operating expense based on our Fiscal Year 1979 business. MITRE did not have a large working capital base then and it does not have one now. MITRE's Working Capital and Contingency Reserve represents less than one month's operating expense, a long way from the goal of three month's operating expense.

Your report (page 8) also states that previous DCAA audits of the fee at MITRE indicated that working capital was more than adequate. It fails to mention that DCAA, in making its recommendation on fee to the Air Force, believed that the Air Force contract provided a contingency clause that would protect MITRE in case of contract nonrenewal or termination. DCAA now knows that no such clause exists.

Page 14, paragraph 2 indicates that depreciation is a reimbursable indirect cost under government cost plus fixed fee contracts. In MITRE's case, depreciation of personal property is allowable while depreciation of real property is unallowable.

Page 15, paragraph 1 states, "However, ... While at both IDA and MITRE these earnings were recorded as revenues of the sponsored organizations they still had not been used to reduce fees. ..."

This statement is incorrect as far as the MITRE contract is concerned since the Air Force does in fact and always has taken into consideration MITRE's Investment Income when it determines and negotiates MITRE's fee.

The report is virtually silent on the extensive Independent Research and Development program undertaken each year by The MITRE Corporation. This is a most important use of fee and has resulted in very early significant contributions to C3I defense programs.

The buildings that we constructed during the 60's through the judicious use of loans and fee income are now fully paid. If we had not done this, and it was clearly not possible for the Government to provide space (we explored every avenue at the time), then we would have had to lease space at considerable additional cost to the government.

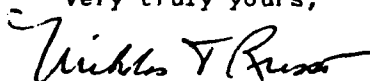
The need for additional space arose in 1979 and after much discussion and exploration with the Air Force as to the best way to obtain that space we constructed 125,000 square feet on MITRE's owned land and occupied that space in January 1980. Presently we have under construction a 170,000 square foot building which we plan to occupy in July 1982. These latest two buildings will cost about \$2,000,000 a year in mortgage payments over a 10 to 15 year period. If we were to lease these buildings, the cost would be about \$3,000,000 per year with no ownership. MITRE has protected the government's interest not only economically, but in the event of dissolution of the Corporation, the buildings will revert to the U. S. Government. Nowhere in the report does the GAO explain how the government could accomplish a building program more cost effective and protective of the government's investment than the MITRE Building Program.

On page 12 the report states: "that when facilities are required to perform work desired by the government, the government should either provide the facilities or cover their cost as part of the contract. In this way, the sponsoring agency would directly provide facilities needed for their contracts, and be able to minimize the costs to the government."

This statement describes the contractual arrangements employed by the Air Force in their negotiation of the MITRE Air Force contract.

If you require further clarification, please contact me at (617) 271-2542.

Very truly yours,



Nicholas T. Russo  
Corporate Controller

NTR:pm



THE JOHNS HOPKINS UNIVERSITY  
APPLIED PHYSICS LABORATORY

Johns Hopkins Road, Laurel, Maryland ~~20007~~ 20707  
Telephone (301) 353-7100 and 792-7500

22 December 1981

Refer to:  
AC-15414

Mr. Donald J. Horan, Director  
Procurement, Logistics and Readiness Division  
United States General Accounting Office  
Washington, D. C. 20548

Dear Mr. Horan:

In response to your letter of 2 December 1981, the Applied Physics Laboratory (APL) of The Johns Hopkins University offers the following comments on your draft report "Fee Guidelines are Required to More Economically and Efficiently Satisfy Needs of Government Sponsored Nonprofit Organizations".

The draft report addresses the question of fees for "government sponsored nonprofit organizations" and in particular those "unique organizations" classified as Federally Funded Research and Development Centers (FFRDCs). That the Laboratory was improperly classified as an FFRDC (FCRC) was acknowledged by the Department of Defense in 1976 when it recommended to the Congress that APL be regarded simply as a university laboratory. The status of APL as a university laboratory has since been acknowledged by the cognizant congressional committees, and we are now recognized as such by the National Science Foundation in their annual series of reports on Federal support to universities and colleges.

With respect to the issues in the report, we wish to point out that the method by which the Navy and The Johns Hopkins University negotiate our fee is in effect based on the needs of the University for managing and operating APL, and has resulted in an exceedingly modest rate of fee - 1.85% of total contract cost in CY 1979. The 3.4% cited in your report is the fee applied only to in-house costs. Whether the government were or were not to use the weighted guidelines method in arriving at their fee target for APL is a moot point, since as your report states, the fee developed by that method would undoubtedly be much higher than the fee requested by the University.

The University has based its request for fee on needs implicit in performing tasks for a variety of federal agencies for almost 40 years. The contractual relationship does not involve sponsorship in the sense of a budget line item or other guaranteed support. Rather, funding for APL is derived from over 150 individual program sources, not only within the Navy and DOD but from other government agencies. The program sponsors assign tasks to APL strictly on the basis of their separate program requirements with no obligation whatsoever to place work at the Laboratory or to support the Laboratory.

Over a period of time, the Navy and the University have addressed the issues cited in your report as possibly being a cause for fees that might be "greater than necessary". Working capital, for instance, is provided by a combination of University funds and an advance payment agreement with the Navy. The use of an advance payment or letter of credit from the government to pay for costs already incurred on behalf of the government is an accepted financing method for providing working capital to educational institutions and certain other contractors. The University has been careful to limit the advance payment to the minimum amount needed to cover payroll and other incurred operating expenses pending processing of regular invoices.

With respect to facilities, the University has provided the land and general purpose buildings for the Laboratory since its beginning and has by formal agreement committed the use of these assets to the government as long as a need exists. At the present time construction of new buildings is financed by state-issued bonds, which require interest payments well below the prime rate, using the existing land and buildings as collateral. The government pays no use charge other than depreciation on the long-term basis allowed by the DAR. Debt service on new construction is a need satisfied by fee. We submit that this method has been the most economical and efficient way for building the APL facility. We are not aware of a method by which the government, as suggested by your report, could have provided the funds for construction of buildings on privately-owned land on a timely basis. It should also be noted that, despite the contrary statement in your report, the University does obtain the concurrence of the Navy that new construction is necessary to performing contract assignments and carrying out the mission of the Laboratory.

With regard to the use of fee to build a fund to protect against contract termination, the need for such a fund was a cornerstone of early agreements between the Navy and the University for operation of APL. The fund has provided a significant measure of security for the Laboratory staff, an important factor in retaining skilled scientific and engineering personnel. Furthermore the invested portion of the fund is an asset of the Laboratory which along with land and buildings is pledged to the use of the government as long as a need exists. Navy and University officials have from time to time discussed the use of termination provisions in the Navy contract to meet this need. However a practicable way has not been found to provide adequate resources from over 150 programs funded within and outside DOD to cover a reasonable transition period following contract termination during which other uses of the Laboratory facility and personnel resources could be developed.

Lastly, it has long been recognized that there is a need for some means of financing legitimate nonreimbursable operating costs. In the case of APL, these costs have been covered by fees received and not by drawing on the general assets of the University. In our opinion, this is a legitimate need. The GAO report notes that these costs might be offset by earnings from the aforementioned fund. However, those earnings

represent the only significant income accruing to the University for managing and supporting the mission of the Laboratory. Unlike most other university laboratories, no part of The Johns Hopkins University management and other overhead costs is included in the APL indirect cost pools.

In summary, we believe that your draft report is in error in including APL as an FFRDC. We do, however, submit that the fee negotiated by the Navy with the University is based on the needs of the Laboratory, is modest by any standards, and has proven to be both an economical and efficient method of providing the necessary support for University efforts on behalf of the U. S. Government. We trust that these comments will be of assistance in formalizing your final report.

Sincerely,



C. O. Bostrom  
Director

COB/CJS/nto



400 ARMY-NAVY DRIVE, ARLINGTON, VIRGINIA 22202 • TELEPHONE (703) 558-1000

December 16, 1981

Mr. Donald J. Horan  
Director  
United States General Accounting Office  
Procurement, Logistics, and Readiness Division  
Washington, D.C. 20548

Dear Mr. Horan:

We have reviewed your draft report "Fee Guidelines are Required to More Economically and Efficiently Satisfy Needs of Government Sponsored Nonprofit Organizations". While we are not in disagreement with all of your conclusions, we have the specific comments set out below:

1. We believe that the summary of excess working capital on Page 8 of the draft report is in error since the \$4,834,873 listed as "Working Capital" for IDA assumes that such items as furniture and equipment are liquid assets and are available to be used as working capital. Further the requirement for liquid assets depends on the maximum days rather than the average days in the operating cycle. The number of days can, during certain times of the year, significantly exceed the average as a result of unfunded contracts at the beginning of a fiscal year or clerical problems encountered in processing the billing invoices. For example, billings sent out on July 9, 1980 were not paid until September 9, 1980 because the checks were misplaced by the Government.
2. Although we agree with the conclusion that the FFRDC's are unique organizations that should receive fees to the extent they are needed to cover financial requirements which cannot otherwise be met under terms and conditions of their contracts, we do not believe that all of the needs have been covered in the draft report nor do we believe that it is feasible to satisfy some of the needs covered in the report.

Examples of "needs" which have not been addressed adequately are audit disallowances, contract overruns, unfunded projects which in some instances are utilized to stabilize the professional staff, acquisition of furniture and other fixed assets, and reserves for termination of long term leases (which in our case extends for 27 years).

We also question the feasibility of having the Government provide facilities and/or reserve funds out of current appropriations for the termination of long term leases.





3. Finally, we would like to point out that at one time many DOD non-profit organizations were under a fee determined by need basis. This apparently did not work out well, probably because each organization is unique (some have parent organizations while others do not, some have built their own facilities while others lease theirs), and "need" is a broad concept susceptible to varying interpretations. There may be many alternative ways for the Government to meet the "needs" of non-profit organizations but many of these are not practically implementable and others do not offer apparent advantages over the present procedures. We believe that a sufficient need could be demonstrated to justify a fee of four or five times the fee we would normally receive this year because of circumstances relating to the leasing of new facilities. However, that is obviously not practical and instead in our planning we have allowed for fund requirements over the long term based on prevailing modest fee levels.

Yours very truly

Arthur W. Boysen



RESEARCH AND  
ENGINEERING

## THE UNDER SECRETARY OF DEFENSE

WASHINGTON, D.C. 20301

20 JAN 1982

Mr. Donald Horan  
Director, Program Analysis Division  
U. S. General Accounting Office  
Washington, D. C. 20548

Dear Mr. Horan:

This is in response to your letter of November 23, 1981, transmitting for comment a GAO draft report entitled "Guidelines for Fees are Required to More Economically and Efficiently Satisfy Needs of Government Sponsored Nonprofit Organizations," (950642) (OSD Case #5830).

The report concludes the fees being paid to three Federally Funded Research and Development Centers (FFRDCs) are not the most economical or effective way to meet the needs of these organizations, and because the fees are not based on needs, it is possible for the FFRDCs to receive more fees than needed.

This conclusion was apparently arrived at based upon two erroneous assumptions made by the GAO. The assumptions are:

- Fees are not needed to accumulate reserves for acquisition of facilities, because it is more economical for the Government to provide the facilities.

We believe this assumption is incorrect. In response to your 1969 report entitled "Need for Improved Guidelines In Contracting for Research with Government Sponsored Nonprofit Contractors (B-146810)" we advised you that "it is DoD policy to encourage contractors to furnish their own facilities, rather than for DoD to do so, unless specific circumstances dictate to the contrary." This is still DoD policy because we believe the FFRDCs generally do a better job of acquiring and maintaining the facilities if they have a vested interest in them. We also told you during your review that we perform economic analyses on FFRDC major facilities acquisitions to determine the most economical way to provide them. The recent evaluation of the "J" building at MITRE, which concluded it was more cost effective for the contractor to acquire the facility, was given to you as a specific example. Finally, and perhaps most fundamentally, the draft report does not address the fact that reimbursement by the Government to the contractor for the cost of facility acquisition normally takes the form of assuming--via the fee--debt service on bonds or commercial loans used by the contractor to acquire the facility. Therefore, there simply is no large pool of funds accumulating from fees and lying fallow until they are used to finance construction or acquisition projects.

- Fees are not needed to accumulate reserves for contract termination because the termination contingency could be accommodated more economically by other means, such as through the use of special termination cost clauses in the contracts.

While it may appear desirable to fund termination liabilities on a contingent liability basis, the GAO should not necessarily conclude it is more economical or fiscally prudent to single out FFRDC contracts, among all other categories of Defense contracts, for blanket coverage with such clauses. This is particularly true since that portion of FFRDC fees earmarked for termination liability coverage is routinely used for other valid, unanticipated needs. This flexibility would be lost, and higher overall sums would have to be budgeted, should funds for termination liability be locked in the Claims, Defense appropriation, as would be necessary under the GAO proposal.

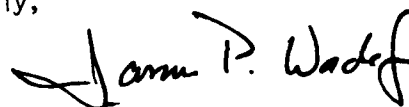
The report further states that DoD is one of the Federal Agencies sponsoring FFRDCs that does not use a needs criteria for determining fees and that the modified weighted guidelines approach, in the opinion of the GAO, is not appropriate for determining fees for FFRDCs. As we pointed out in our response to your 1969 report, the weighted guidelines approach was adopted specifically for the purpose of offsetting some of the weaknesses the needs approach was considered to have such as failing to give any recognition to merit, excellence of effort, past achievement, and other such factors. Since 1966 it has been DoD policy to use the weighted guidelines approach, tempered with a critical evaluation of the needs for capital accumulation to assure the fees negotiated with FFRDCs and other not-for-profit organizations are not excessive. Specific examples of the application of this policy were provided to the GAO auditors during the review.

In view of the above, we strongly question the implication that the DoD has provided \$19 million of fees in excess of the legitimate needs of the three organizations sponsored by DoD contract activity. We find no evidence in the report that would lead us to believe the fees negotiated by DoD contracting officers were not in accordance with the above DoD policy. In addition, we do not find any evidence to indicate the fee levels are unreasonable or have been provided for any purpose for which they were not intended.

The report recommends that the Office of Management and Budget, through OFPP, establish a needs criteria for determining the fees of sponsored organizations through the most economical and effective means available. The DoD has no objection to this recommendation, but we do not believe it is necessary in our case, since we believe our policies are fulfilling the legitimate purposes for which they were intended.

In summary, we do not believe that the assumptions made by the GAO are valid or supportable. In addition, we do not agree with GAO's conclusion. While we have no objections to OFPP undertaking an effort to develop fee criteria based on needs we do not believe that it is necessary or cost effective for DoD purposes.

Sincerely,



James P. Wade, Jr.  
Acting

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DATE  
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